United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

75-7051

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

- -x

FIRST NATIONAL BANK OF HOLLYWOOD, DOROTHY BUCHMAN and SANDER BUCHMAN, as Executors of Samuel Buchman,

Plaintiffs-Appellees,

Docket No. 75-7051

-against-

AMERICAN FOAM RUBBER CORP., MILTON R. ACKMAN as Trustee of American Foam Rubber Corp., Bankrupt, MARIE LOUISE de MONTMOLLIN, ALEXANDER F. PATHY and SUZANNE M. PATHY,

Defendants-Appellants.

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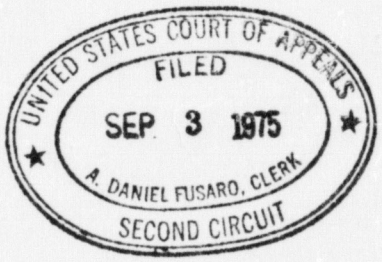
REPLY BRIEF FOR DEFENDANTS-APPELLANTS



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REPLY BRIEF OF
DEFENDANT-APPELLANTS

Preliminary Statement

This brief is submitted by defendants-appellants (the "Individual Defendants"), Marie Louise de Montmollin, ("Mrs. Alexander Pathy ("Pathy"), and Suzanne M. Pathy, ("Mrs. Pathy") in reply to the brief submitted by plaintiffs-appellees (the "appellees"). It is respectfully submitted that appellees' brief fails to deal, in any meaningful way with the arguments presented in the Individual Defendants' principal brief. Appellees have, instead, attempted to cloud the issues and to present to this Court some novel propositions of law.

Before turning to the new substantive issues

raised by appellees' brief, it is important to clarify a procedural matter to which appellees have inaccurately referred. The Appellees state, on page 2 of their brief, that:

> "It was not until July 8, 1975 that appellee came to the realization that she needed counsel's help in presenting her legal argument on this appeal. Since appellee's request for enlargement of time was granted to August 11, 1975, and the proceedings lasted over a period of 10 years, counsel were unable to read the voluminous papers on file. Our brief is our best effort under the circumstances."

This statement is wholly inaccurate. The events leading to the enlargement of appellee's time to file their brief are summarized as follows.

This appeal was taken on January 9, 1975. At that time, the firm of Lotwin, Goldman, Gutin, Rosen & Greene (the "Lotwin firm"), counsel of record for the appellees was properly served with a copy of the notice of appeal. Following the service and filing of the notice of appeal, and pursuant to the Civil Appeals Management Plan a pre-argument statement was filed and, at the request of staff counsel to this Court, a pre-argument conference was held on January 28, 1975. The conference was attended by counsel to the Individual defendants and one Herbert Bell, Esq. of the Lotwin firm. Mr. Bell was accompanied by Max I. Cohen, Esq., the brother-in-law of appellee Dorothy Buchman. The Individual defendants' counsel were then informed that

neither Bell nor the Lotwin firm had been engaged by the appellees to represent them on this appeal.* Mr. Fensterstock strongly urged Messrs. Bell and Cohen that they communicate to Dorothy Buchman the importance of having an attorney represent her on this appeal.

Thereafter, as counsel proceeded, in accordance with the several scheduling orders of this court, to assemble the record on appeal and prepare the principal brief, several discussions were held between and among the Individual defendants' counsel and Messrs. Bell and Cohen. During the course of those discussions, the last of which took place on or about February 13, 1975, counsel were informed that no decision had yet been reached regarding the representation of appellees on this appeal.

Thereafter, appellee Dorothy Buchman sent several letters to the Individual defendants' counsel, the second of which is cited in the appellees' brief. On February 8, 1975, counsel replied to those letters, stating:

> "I understand that Mr. Bell does not represent you on the appeal we have taken. It is urged that we be advised of who your attorneys are in this matter."

Following some further communication between counsel and Mrs. Buchman, counsel received the following telegram:

> "DEAR MR. SIVE YOUR LETTER OF FEBRUARY 18TH AT HAND. REVIEWING MR. FENSTERSTOCK'S

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* Mr. Bell was, at that time, in the process of leaving the Lotwin firm.

SCHEDULING ORDER NUMBER 2 DATE OF FEBRUARY 5TH 1975 I NOTE THE TIME FOR YOUR FILING OF BRIEF ON APPEAL NO LATER THAN MARCH 17TH. UPON READING THE CONTENTS OF YOUR BRIEF I SHALL THEN MAKE MY DECISION AS TO WHICH ATTORNEY I SHALL ENGAGE TO DEFEND THIS ESTATE IN THIS COURSE OF ACTION. SINCERELY
DOROTHY BUCHMAN"

Shortly after receiving the above-quoted telegram, counsel began to prepare the joint appendix and, pursuant to Rule 30(b) Fed. R. App. Pro., were required to serve a designation of contents of the appendix upon their adversaries. Letters requesting the name of the appellees' counsel were sent to Bernard Rosen of Lotwin firm and to Herbert Bell. Counsel were informed that neither the Lotwin firm nor Bell had been retained by appellees. Consequently, the brief and appendix were filed by Individual defendants on April 4, 1975*, and were served on Dorothy Buchman.

Thereafter, on or about May 5, 1975, the due date for appellees' brief, counsel were advised by personnel of the Court that Mr. Buchman had made a pro se application for an extension of time in which to file her brief on the ground that she had not yet retained counsel. The said application was granted by this Court, in an order dated May 22, 1975 and appellees were given until August 1, 1975.

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*During the course of the proceedings described above, it was necessary to secure modifications of the date for the filing of appellants' brief and the appendix herein. Scheduling Order #4, dated March 24, 1975, required that appellants' brief and joint appendix be filed on or before April 4, 1975 and the appendix and appellants' brief were so filed.

It was not until July 8, 1975, some six weeks after the granting of Mrs. Buchman's application that counsel was retained and a motion for a further extension of time was made.

Thus, contrary to the apologetic, sympathy-seeking statement in appellee's brief regarding the time strictures involved in this application, it should be noted by this Court whatever time problem appellees had in the preparation of said brief was the result of the principal appellee's (Mrs. Buchman) deliberate and irresponsible conduct.*

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* Appellants' attorneys are in no respect critical of Appellees' present attorneys as distinguished from appellee Dorothy Buchman.

POINT I

APPELLEES MAKE NO SERIOUS ATTEMPT TO CONTROVERT THREE OF THE FOUR POINTS OF APPELLANTS' BRIEF

Individual Defendants make four points in their principal brief:

I. In ruling upon the Exchange Transaction the District Court erroneously substituted consideration of general principles of subordination for construction of the Subordination Agreement.

II. The District Court erred in holding that it is a breach of a subordination agreement for a junior creditor to discharge a subordinated debt.

III. The Loan Transaction did not result in any payment of any of the debentures.

IV. The District Court committed reversible error in determining the Subordination Claim upon a theory of law neither pleaded nor tried.

Appellees make a serious attempt to rebut only Point III.

A. The District Court's Consideration of General Principles of Subordination Rather than the Language of the Subordination Agreement

The District Court, in its decision of July 23, 1969, substituted a lengthy discussion of the generic law of subordination agreements (221a-232a) for its own previously

stated construction of particular subordination agreement which is the basis of this action. Point I of the Individual Defendants' principal brief demonstrates that the District Court's action in basing its decision regarding the Exchange Transaction on those general principles was erroneous. This argument can be briefly summarized as follows:

The Subordination Agreement clearly provided that the Individual Defendants were not entitled to payment on the subordinated debentures unless Buchman had been paid in full. On two separate occasions, the District Court construed the language of the Subordination Agreement, stating that its plain meaning was "to prohibit [the individual] defendants from realizing any cash or its equivalent from the corporation until Buchman's debentures had been satisfied in full." (81a) (underscoring supplied). This same construction was subsequently quoted and reaffirmed (R 137).

In its July 23, 1969 opinion, the District Court specifically found that the Exchange Transaction was not "a first step of a plan to obtain cash or cash recognizable property -- from AFR". (218a).

Despite this clear holding and the firmly established principle of law that contracts are to be interpreted by their

language, not their labels, Pan-American Bank & Trust Co. v. National City Bank, 6 F.2d 762, 766 (2d Cir. 1926), the District Court proceeded to hold for appellees, basing its decision that the Subordination Agreement was breached upon purported general principles of subordination.

Appellees do not answer this point. They do attempt a dissertation on the "law of subordination", citing two of the same law review articles cited by the District Court* as well as the two cases upon which the decision heavily relied. In Re Cherno v. Dutch American Mercantile Corp., 353 F.2d 147 (2d Cir. 1965); and In Re Dodge-Freedman Poultry Co., 148 F.Supp. 647 (D. N.H.), aff'd sub nom., Dodge-Freedman Poultry Co. v. Delaware Mills, 244 F.2d 314 (1st Cir. 1957).**Appellees also cite numerous other cases dealing with subordination agreements in Bankruptcy proceedings (See Appellees' brief, pp. 21-23). Nowhere, however, do appellees cite any authority for the proposition that general principles of a generic area of the law should supplant the particular language of an agreement in order to determine the rights and duties of the parties to the agreement.

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* Caligar, Subordination Agreements, 70 Yale L.J. 376 (1961); and Coogan, Knipler and Weiss, The Outer Fringes of Article 9: Subordination Agreements, Negative Pledge Clauses, And Participation Agreements, 79 Harv.L.Rev. 229 (1965) (Incorrectly cited by Appellees as "Coogan Krople & Weiss, 79 Harv.Law Review 229 at 234").

** As pointed out in Individual Defendants' principal brief, both cases involved what were held to be unconscionable "inequitable ... and fraudulent scheme[s]" to deprive senior creditors of the security for claims. Dodge-Freedman, supra at 649, and Cherno, supra at 149, respectively.

B. The District Court's Improper Holding That A Subordination Agreement is Breached by A Discharge of the Subordinated Debt

Point II of the Individual Defendant's principal brief documents the error of the District Court in ruling that any subordination agreement is breached by the discharge of the subordinated debt. Individual Defendants assert that the cases cited by the Court as authority for its ruling, Dodge-Freedman, supra, and Cherno, supra, hold that in particular circumstances, the discharge of a junior debt may violate the provisions of a particular subordination agreement.

Despite the extensive discussion of the inapplicability of Cherno and Dodge-Freedman to the facts before this Court, the Appellees make no attempt to demonstrate their applicability. Instead, Appellees cite six Bankruptcy cases involving subordinated debts, none of which is relevant to this matter.

In Re Aktiebolaget Krenger & Toll, 96 F.2d 768, (2d Cir. 1938) is cited for the proposition that Section 64b and 65a of the Bankruptcy Act recognize established contractual priorities among creditors. The Individual Defendants do not disagree. Bank of America Nat'l Trust & Sav. Ass'n v. Erickson,

117 F.2d 796 (9th Cir. 1941)* is cited for the proposition that "The Bankruptcy Court. . . has the jurisdictional power to enforce the contractual rights of the parties in interest when distributing bankrupt's estate." (p. 22) Again, this is not disputed.

The four remaining cases cited are inapplicable. Wyse v. Pioneer-Cafeteria Feeds, Ltd., 340 F.2d 719 (6th Cir. 1965), for example, is incorrectly cited by the Appellees for the proposition that a stockholders' agreement to postpone payments due him from the corporation to claims of a creditor is a "complete subordination", involved a subordination agreement incident to a guaranty. The principal issue in that case was whether a claim in bankruptcy by the creditor was properly payable. There was no discussion at all relevant to the issue of the breach of subordination agreements.

In Re Credit Industrial Corp., 366 F.2d 402 (2d Cir. 1962) involved a claim by individual creditors of a bankrupt, who had subordinated their claims to institutional creditors. The quotation contained in Appellees' brief (pp. 22-23) relates to a claim by one of the parties that the subordination provisions in question were vague and not

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* Cited by Appellees as "Bank of America Nat'l. Trust & Sarassin v. Erickson".

applicable in bankruptcy. It has no bearing on the issues before this Court. The claimants in Credit Industrial Corp. sought payment of their claims. The court denied them because of the terms of the particular agreement before it.

Part of the opinion in Credit Industrial supports the Individual Defendants' assertion that the "test of Buchman's rights herein with respect to the exchange was the terms of the Subordination Agreement, not concepts of equity at the time of bankruptcy." (Appellants' brief, p. 30). In discussing subordination, the Court stated:

> "Moreover, the enforcement of such agreements is not based on any theory of equitable estoppel. In our opinion, the district court erroneously relied on the doctrine of equitable estoppel as a basis for its position and failed to recognize the distinction between equitable and consensual subordination, which is founded upon estoppel, is the doctrine invoked by courts to deny equal treatment to creditors based on some inequitable or unconscionable conduct in which they have engaged, or a special position which they occupy vis-a-vis the bankrupt that justifies subordination of their claims. 3 Collier supra §§ 57.14, 65.06; see Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939). On the other hand, consensual or contractual subordination, of which the debt subordination agreements involved here are prime examples, occurs when a creditor and the bankrupt agree to create priorities among debts. Such agreements have been uniformly enforced according to their terms by bankruptcy courts." Id. at 408.

Appellees have in no way refuted the Individual Defendants' statement of the law applicable to this Subordination Agreement.

C. The Improper Procedures Followed by the District Court

Point IV of Individual Defendants' brief discusses, in necessary detail, the error of the District Court in basing a decision on a claim neither pleaded nor proven, by substituting the "double dividend" in bankruptcy theory for the District Court's own earlier definition of "payment" (219a, 239a), and sua sponte re-opening the trial.

Appellees' only reference to this entire point is found on page 13, where they state that the Individual Defendants claimed that the Loan Transaction was not pleaded and should not have been considered. This statement indicates that Appellees did not bother to read closely Individual Defendants' brief. On page 43 of this brief, the Individual Defendants state:

> "The pretrial order amended paragraph 'SEVENTEENTH' only, by adding the Loan Transaction and the Pathy-de Montmollin Sale to the Exchange Transaction."

This clearly shows that the Individual Defendants do not claim that the Loan Transaction should not have been considered.

POINT II

APPELLEES' DISCUSSION OF THE LOAN TRANSACTION ERRONEOUSLY STATES THE LAW

The Loan Transaction, by which Mrs. deMontmollin surrendered $15,000.00 in debentures of Burlington in exchange for a credit on its books and, thereafter, lent the same $15,000 to AFR, receiving a note, was a bookkeeping transaction undertaken to enhance the capital structure of AFR by reducing its and its subsidiaries' long-term debt. She never received any cash or cash realizable property from AFR; nor did she at any time intend to do so. (See testimony of Pathy, 183a, 184a).

Appellees, on the other hand, claim that this transaction constituted "payment" to Mrs. deMontmollin, in violation of the Subordination Agreement. They state that:

> "Taking a note in payment, and not merely as evidence of a debt extinguishes the debt. Schalom v. Zuckerbarat, App. Div. 2d Dept. - 29 App. Div. (2) 571, 286, N.Y.S. (2) 364. (Sic)" (p. 13) (emphasis supplied)

The case cited by Appellees, Sholom & Zuckerbrot Queens Leasing Corp. v. Forate Realty Corp., 29 App.Div. 2d 571, 286 N.Y.S.2d 364 (2d Dep't 1957) stands, however, for the proposition stated in Appellees' brief only where the parties agree that the taking of the note is payment. The language of the opinion clearly demonstrates this:

> "[T]he parties agree that the promissory note of September 12, 1966 was delivered and accepted in payment of the first installment due under the letter agreement. Taking the note in payment, and not merely as evidence of the debt, extinguished the debt and defendant was not in default under the agreement (Industrial Bank of Commerce v. Shapiro, 276 App.Div. 370, 372, 94 N.Y.S. 2d 437, 439, affd. 302 N.Y. 566, 96 N.E.2d 619)."

By glossing over the requirement that the parties agree that the note is given in payment rather than a evidence of a debt, Appellees have misstated the law.

Industrial Bank of Commerce v. Shapiro, 276 App.Div. 370, 94 N.Y.S.2d 437 (1st Dep't 1950), cited by Appellees (p. 16), is persuasive on this point.

> "A promissory note is delivered as evidence of a debt, rather than in payment thereof, unless there be an agreement that the note is received in payment of the debt." Id. at 439 (emphasis supplied)

To support this, the Court cited Jagger Iron Co. v. Walker, 76 N.Y. 521, 524 (1879).

> "These cases all go upon the principle, that the taking of a debtor's note, does not merge or extinguish the demand for which it is taken. The original consideration remains. Indeed, but for the original consideration, the note would have no force. It is but a promise to pay, put in writing. If there is no debt existing to be paid, the promise to pay it is, so to speak, null. The promise to pay is not payment, when first made, nor when at any time it is renewed." Shapiro, supra, at 439

In the Loan Transaction, Mrs. deMontmollin took the note from AFR as evidence of indebtedness, not in payment thereof. As the uncontradicted testimony of Pathy clearly shows, there was no agreement between AFR and Mrs. deMontmollin that the note was payment. On the contrary, Mrs. deMontmollin never expected AFR to pay her $15,000, nor did she ever demand payment of the note prior to Buchman's receiving payment on the debentures. She did not receive "payment" for the Burlington debentures.

POINT III

THE EXCHANGE TRANSACTION DID NOT RESULT IN THE INDIVIDUAL DEFENDANTS' RECEIVING "PAYMENT" ON THEIR DEBENTURES

Appellees cite numerous cases to support their contention that the discharge of a debt, in any form, constitutes "payment" of that debt to the creditors, as that term was used in the Subordination Agreement. None of these cases, however, deals with payment of a subordinated debt as defined by a particular agreement. They deal with matters such as what constitutes payment as a disguise to an admiralty claim, United States v. Isthmian Steamship Co., 359 U.S. 319 (1959); a surety's obligations, Chrysler Corp. v. Hanover Ins. Co., 350 F.2d 652 (7th Cir. 1965); "payment" as defined by the Interstate Commerce Act, Arkansas St. v. U.S., 193 F. 667 (Commerce Ct. 1911).

Appellees also cite LaMontague v. Bank of N.Y. Nat. Banking Ass'n., 94 App.Div. 291, 88 N.Y.S. 21 (1st Dep't 1904)* as lending support to a generalized concept of payment but neglect to advise the Court that the language to that effect is contained only in the concurring opinion. Moreover, that language also defines payment of an obligation as ". . .anything

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* Incorrectly cited as "In Re Montague v. Bank of N.Y., 99 N.Y.S. 21, 31, 94 A.D. 219"

which is accepted by the creditor as the equivalent of money and in satisfaction thereof." Id. at 31. The District Court explicitly found that the preferred stock received by virtue of the Exchange Tran action was not received by the Individual Defendants as money or its equivalent. (218a)

Appellees also advance the novel proposition that "The spirit of the buy-sell agreement requires an equitable and legally tenable interpretation. The very acts of increasing AFR's debt jeopardizing AFR's ability to pay B's debentures is sufficient warrant for equating discharge with payment. (sic)." (p. 17) Appellees would have this Court believe that the Individual Defendants destroyed AFR, and should be punished by having the Court misconstrue the meaning of "payment" in the Subordination Agreement. The jury, of course, found that Buchman, not the Individual Defendants, had conspired to destroy AFR (153a). Certainly, the equities lie with the Individual Defendants and require a reversal of the judgment against them.

CONCLUSION

For all of the foregoing reasons, the judgment of the District Court appealed from should be reversed and judgment entered in the Individual Defendants' favor dismissing the complaint herein, and awarding costs of this appeal to them.

Dated: New York, New York
September 2, 1975

Respectfully submitted,

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Of Counsel:

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Richard Guy Leland, Esq.

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.:

RICHARD GUY LELAND, being duly sworn, deposes and says:

Deponent is over the age of 18, is not a party to this action and resides at 23 Range Drive, Merrick, New York 11566.

That on the 3rd day of September, 1975, deponent served the within Reply Brief for Defendants-Appellants upon JACOB E. HELLER and JOSEPH E. HELLER, attorneys for appellees, by delivering two (2) copies thereof at their offices at 51 Chambers Street, New York, New York.

Richard Guy Leland
RICHARD GUY LELAND

Sworn to before me
this 3rd day of
September, 1975

RUTH GERSHON
Commissioner of Deeds, City of New York
New York County Clerk's No. 2-79
Commission Expires September 1, 1976